CUBICASSET MANAGEMENT, LLC

2009 1st Quarter Stock Market Commentary

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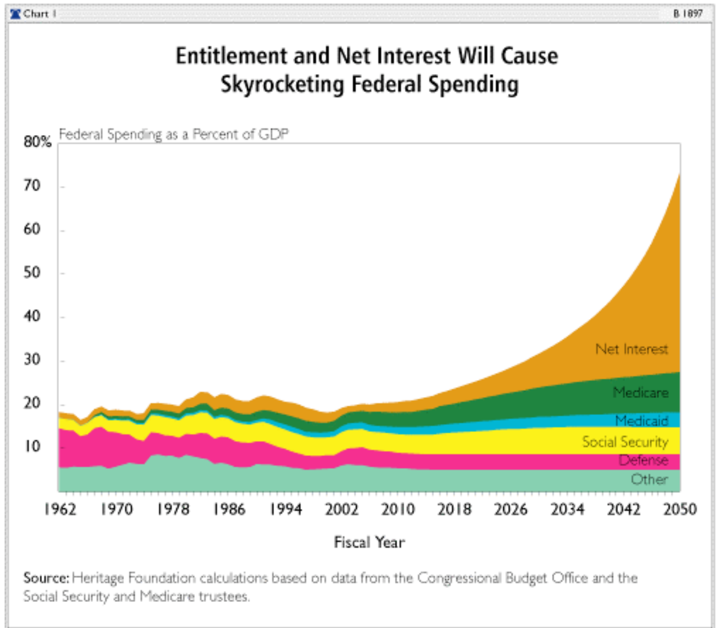
Christmas is a time when kids tell Santa what they want and adults pay for it. Deficits are when adults tell the government what they want and their kids pay for it.
- Richard Lamm

The late Senator Everett Dirksen, Republican Senator from Illinois, is best remembered for a quip attributed to him that he never actually made. In referring to runaway government spending, he is incorrectly quoted as having said, "A billion here, a billion there, pretty soon it adds up to real money." It's too bad that Dirksen, who died in 1969, didn't live until today. He'd have had to update his witticism to use trillions, rather than billions. It is nearly impossible to grasp how big a trillion is. If you started counting one number per second, and continued twenty-four hours a day, seven days a week, it would take 11 days to count to a million. It would take almost 32 years to count to a billion. But it would take 32,000 years to count to a trillion. To put that in perspective, 32,000 years ago there were still Neanderthals roaming the Earth. And yet the U.S. government committed nearly a trillion dollars of taxpayer money to bail out the major banks from their collective delusion that real estate values could only go up. It is following that up with another two trillion dollars in stimulus programs to bolster the reeling U.S. economy. If laid end to end, a trillion dollar bills could more than reach the sun, which is the only way to burn up money faster than our elected representatives.

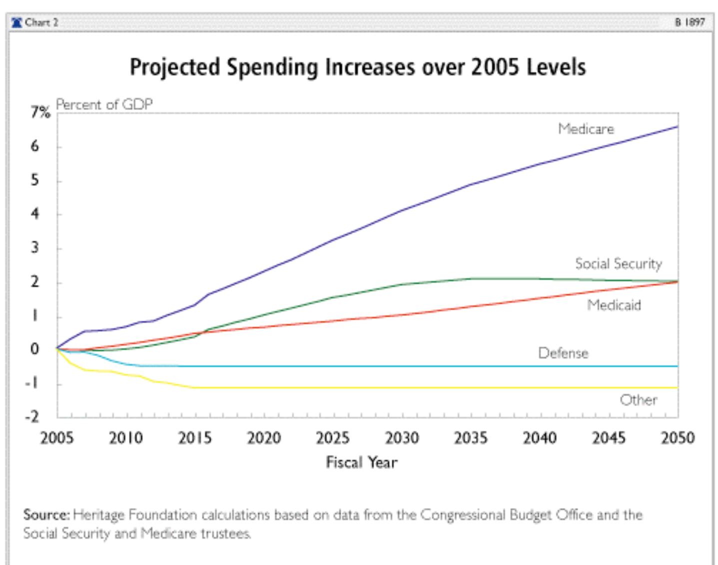
But as staggering as these sums are, they pale into insignificance against the unfunded obligations of the Medicare and Social Security programs. Currently, roughly 12.5% of the total federal income tax revenue is transferred to support the cost of Medicare. The Social Security Trust Fund still has a small surplus. If present trends continue, the Trustees of the Medicare Trust Fund project that Medicare alone will absorb 74.8% of income tax revenue by 2080, and Social Security will use another 17%. There won't even be enough left over to pay for free haircuts for Senators, not to mention fact-finding junkets to beach locations around the world. The Trustees have reported that the combined Medicare/Social Security unfunded obligation is $36.7 trillion over the next 75 years, and $83.9 trillion using an infinite horizon.

In Chart 1 below, we show the projected portion of GDP necessary to pay for the three principal entitlement programs, plus interest on the national debt. The looming crisis in Medicare is by far the most serious. Social Security, Medicare and Medicaid are all adversely impacted by the aging of the Baby Boomers. Social Security, though, is primarily a transfer program which shifts income from current workers to retirees. Medicare (and Medicaid), by contrast, are impacted by the rapidly rising cost of delivering technologically advanced health care to an aging population. Historically, the annual cost per enrollee in Medicare has grown 3% per year faster than GDP.



As noted, this chart is based upon data from the Congressional Budget Office and the trustees of the Medicare and Social Security Trust funds. The data was compiled in 2005. As such, it grossly understates the problem, since interest on the national debt is dramatically higher (due to stimulus spending and bailouts) and GDP is running well below projected levels.

Chart 2 recasts the data in a different manner, using 2005 as the baseline. Here the projected surge in Medicare becomes even more apparent. Historically, Federal tax receipts have averaged approximately 20% (or 1/5th) of GDP, so that a program which consumes 7% of GDP is eating up 35% of all Federal taxes.



As scary as these figures are, they actually represent an extraordinarily optimistic view. Congress, which prefers to defer all financial bad news until after every foreseeable Election Day, has passed a law which requires the Congressional Budget Office to prepare all of its forecasts using the following assumptions. (As Dave Barry would say, "I am not making this up".)

1) There will be no additional supplemental spending for the war on terrorism.

2) Congress will limit discretionary spending increases, which have averaged 9% per year for this decade, to the inflation rate (which last year was only 0.1%).

3) Congress will allow the 2001, 2003 and other tax cuts to expire and not update the income thresholds for the Alternative Minimum Tax.

PULEEZE! Our legislators must have trained at the Mad Magazine School of Government, which advises every candidate to use the all-purpose campaign slogan "What, me worry?"

What can be done? The options available to fix the potential shortfall in Social Security are reasonably straightforward. The most obvious, and the least likely to be enacted, is simply to reduce the benefit. Other alternatives include increasing the age of retirement, raising the FICA payroll tax, or means testing benefits. In all probability, some combination of these three measures will be required, although none are likely to pass in the near future with the senior population suffering from their nest eggs.

Proposals to remedy the ballooning deficit in Medicare vary widely, depending which side of the political aisle one is on. President Obama has stated unequivocally that we should not reduce Medicare benefits, as cuts would hurt those Americans most in need of care. Instead, he hopes to lower program cost by reducing waste and abuse in the broader health care system, since it has traditionally been the rise in health care costs which have driven increases in the cost of Medicare. It is hard to be against reducing waste and abuse, but the sad fact is that these account for a very small portion of the overall cost of the program. In the United States, a complicated claims process and high marketing costs have resulted in overhead roughly double that incurred in other developed nations. But the effect is minor, because the total of all administrative costs is only 7% of total health costs. If the government could somehow streamline the system to slash administrative costs in half, this would offset only six months of the annual growth in health spending, which has averaged 6-7% annually.

Conservatives believe that costs can best be contained by encouraging competition in health care, and that the government should not be subsidizing the cost of Medicare Part B and Part D for high-income individuals. Here, too, the facts suggest otherwise. Health care is the only industry in which competition drives up prices, rather than forcing them down. After all, if one hospital installs an expensive linear accelerator to treat cancer patients, or an extracorporeal shock wave lithotripter to break up kidney stones, every other hospital in the area needs to ramp up its spending or risk losing its patients who prefer the latest technology. If a pharmaceutical company, such as Pfizer, wants to defend the market share of its cholesterol-reducing statin Lipitor against inroads from Merck's Vytorin or AstraZeneca's Crestor, it has to sharply increase its marketing expenses, which the other companies must then match. These costs must be passed along in the form of higher prices.

Unfortunately, this fiscal crisis is unfolding in slow motion. Government being government, it is unlikely that meaningful reform will occur until the crisis is so acute that it can no longer be pushed off past the next election. After all, airport security was beefed-up after 9/11, and disaster preparedness was only improved after the devastation of Katrina. Only after nearly 10% of all home mortgages went into default did it occur to our elected officials that encouraging universal home ownership was misguided, despite numerous warnings to that effect along the way. Energy conservation will again become a priority only when we next face sky-high oil prices. The sad fact is that our leaders are not leaders at all, but are simply followers, reacting to crisis after crisis. Earthquake victims in Turkey can get relief supplies airlifted in within a day, but global warming will not be addressed seriously until New York and San Francisco are under water.

While politicians may not be able to move proactively, we as investors can and should. The looming deficits are so massive that they will force the government to issue an unprecedented amount of long-term debt. It seems improbable that Chinese and Middle East sovereign funds will finance our profligacy at today's low interest rates. Almost inevitably, long term rates will have to rise. This suggests that within a few years, conservative balanced accounts should begin shortening bond maturities, while more aggressive accounts may want to go short long-term treasury bonds or futures. The dollar will likely come under pressure, too. It is not guaranteed, though, that the U.S. dollar will decline relative to the currencies of our major trading partners, such as Great Britain, Japan or the European Economic Community. After all, they share many of our fiscal woes, so the pound, yen and euro may come under pressure, too. But it is almost sure that the dollar will decline against hard assets, like gold, silver or platinum. Most portfolios should add exposure to such assets over the next decade. Finally, if health care spending will comprise an ever larger portion of GDP, eventually government officials will try to rein in those expenses. It seems reasonable to include some companies in every portfolio whose business is focused on healthcare cost containment. It's probably a good idea to buy a rowboat before there's water up to your windows.

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